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No. 82-1737

In the Supreme Court of the United States

OCTOBER TERM, 1982

ELLIS BANKING CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Petitioner seeks review of the decision of the court below in this federal income tax case holding that expenditures made in connection with the acquisition of corporate stock are not deductible as ordinary and necessary business expenses under Section 162 of the Internal Revenue Code of 1954 (26 U.S.C. (& Supp. V)), but must, instead, be capitalized as part of the cost of that stock.

The pertinent facts may be summarized as follows. Petitioner is a Florida bank holding company. In 1973, it offered to exchange shares of its stock for all the issued and outstanding stock of Parkway National Bank of Tallahassee, subject to certain conditions.* In 1974, after this offer

*During the period in issue, Florida allowed banks to expand into new market areas only through the purchase of stock of existing banks or the formation of new subsidiary banking corporations (Pet. App. A-3).

was accepted, petitioner expended $9,077.44 in the course of investigating whether the conditions could be fulfilled. Of that amount, $5,894 represented accounting fees for services in connection with the proposed acquisition and with the registration of the shares to be used in the acquisition; $3,041.58 represented travel expenses for employees who went to Tallahassee to examine Parkway's books. The remaining $141.85 was allocable to office supplies and filing fees (Pet. App. A-4).

Petitioner deducted all of the expenditures as ordinary and necessary business expenses on its 1974 federal income tax return. On audit, the Commissioner of Internal Revenue disallowed the deductions on the ground that the expenditures should be capitalized as part of the cost of acquiring the Parkway stock (Pet. App. A-23). The Tax Court upheld the Commissioner's determination (Pet. App. A-31). The court of appeals affirmed the Tax Court's ruling that petitioner's costs of acquiring the Parkway stock were not deductible, but remanded the case for consideration whether petitioner incurred any part of the accounting fee for general auditing services rather than for services relating to the acquisition of Parkway stock (Pet. App. A-12 to A-14, A-32).

1. The courts below correctly required capitalization of the accounting fees and other expenditures incurred by petitioner in connection with the acquisition of the Parkway stock. Section 162 of the 1954 Code permits the deduction of ordinary and necessary business expenses incurred or paid during the taxable year. *Commissioner* v. *Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971). But the Code prohibits deduction of capital outlays on the "basic principle that a capital expenditure may not be deducted from current income" (*Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 16 (1974)). See also *Commissioner* v. *Lincoln*

Savings & Loan Ass'n, supra, 403 U.S. at 358; *Woodward* v. *Commissioner,* 397 U.S. 572, 574-575 (1970). The term "capital expenditure" or "capital outlay" includes any expenditure incurred in acquiring a capital asset. "The law could hardly be otherwise, for such ancillary expenses incurred in acquiring or disposing of an asset are as much a part of the cost of that asset as is the price paid for it." *Woodward* v. *Commissioner, supra,* 397 U.S. at 575, 576; *United States* v. *Hilton Hotels Corp.,* 397 U.S. 580 (1970).

Here, the expenses petitioner sought to deduct were directly related to establishing the proper price of the Parkway stock, to determining whether the conditions to which the acquisition was subject were fulfilled, and to obtaining the necessary governmental approval of the proposed exchange of shares. The fact that petitioner could have abandoned the planned acquisition if the conditions were not fulfilled or if the approval were not obtained is irrelevant to the question whether the expenditures were capital or ordinary, as long as they were made in the expectation that they would "result in the creation of a capital asset" (*Union Mutual Life Ins. Co.* v. *United States,* 570 F.2d 382, 392 (1st Cir. 1978)). If the prospective transaction had been aborted, presumably the outlays related to it could have been deducted as losses under Section 165, but since the transaction in fact went forward, the outlays of the "whole process of acquisition" were properly capitalized. *United States* v. *Hilton Hotels, supra,* 397 U.S. at 584.

2. Contrary to petitioner's contentions (Pet. 9-12), the decision below does not conflict either with this Court's decision in *Commissioner* v. *Lincoln Savings & Loan Ass'n, supra,* or with *NCNB Corp.* v. *United States,* 684 F.2d 285 (4th Cir. 1982). In *Lincoln Savings & Loan Ass'n,* this Court held that a savings and loan association's mandatory contribution to a secondary reserve maintained by the

Federal Savings and Loan Insurance Corporation was not deductible under Section 162 because it was a capital expenditure that served "to create or enhance * * * a separate and distinct additional asset." 403 U.S. at 354. As the court below correctly noted (Pet. App. A-8 n.7), the expenditures here in issue likewise served "to create or enhance a separate and distinct additional asset," namely the Parkway stock. Accordingly, the result reached here is not only consistent with the reasoning of *Lincoln Savings* but compelled by it.

Nor does the decision in this case conflict with *NCNB Corp.* There, the issue was whether the cost of certain market studies regarding the establishment of bank branches, and in-house salaries of employees working on expansion planning, could be currently deducted. Unlike the instant case, the expenditures in question were not directed toward the acquisition of corporate stock or the business assets of another company, but simply toward the growth of that taxpayer's own business. The decision held that the surveys themselves were not separate and identifiable assets, and that the expenditures incurred to create them were therefore deductible under Section 162 of the 1954 Code. 684 F.2d at 294. Whatever the merits of that analysis, there is no question here but that the Parkway stock was, in fact, a separate and identifiable asset.

Petitioner further claims (Pet. 9) that the decision below is contrary to *Lincoln Savings & Loan* and *NCNB Corp.* because it adopted a "one-year" rule for distinguishing between current expenditures and capital outlays. Although the useful life of an asset is not irrelevant in determining whether its cost must be capitalized (*Woodward* v. *Commissioner, supra,* 397 U.S. at 575-576), the opinion below did not adopt a "one-year" test to determine whether an asset created by an expenditure was capital. The court of appeals recognized the difficulty of proper characterization

in other cases where the asset was not tangible or was not readily identifiable. After referring to both this Court's opinion in *Lincoln Savings & Loan Ass'n*, and to decisions from other circuits (Pet. App. A-8 n.7), it concluded that, under this Court's *Woodward* decision, there was no question that the Parkway stock in this case was properly characterized as a capital asset (*ibid.*). Hence, the decision below did not turn on the application of one-year rule.

3. Petitioner also argues (Pet. 10) that Section 195 of the 1954 Code automatically permits the deduction of all "start-up" expenses in connection with a new business. But Section 195 of the 1954 Code does not recharacterize capital expenditures into deductible ordinary and necessary business expenses. It allows a new business to amortize certain "start-up" expenses. Section 195(b)(2) limits the reach of that statute to amounts that would have been deductible if spent to expand an existing business rather than to start a new business. Furthermore, the legislative history makes clear that Congress had no intention of affecting the character of the expenditures at issue here. As the House Committee Report stated (H.R. Rep. No. 96-1278, 96th Cong., 2d Sess. 11 (1980)):

> Startup expenditures eligible for amortization do not include any amount with respect to which a deduction would not be allowable to an existing trade or business for the taxable year in which the expenditure was paid or incurred. Thus, amounts paid or incurred in connection with the sale of stock, securities, or partnership interests are not within the definition of startup expenditures, e.g., securities registration, expenses, underwriters' commissions, etc., are not startup expenditures.

Finally, petitioner argues (Pet. 11) that its conditional contract to buy the Parkway stock had no value and that, based on *Briarcliff Candy Co.* v. *Commissioner*, 475

F.2d 775 (2d Cir. 1973), the costs associated with the acquisition of that contract were therefore not capital expenditures. *Briarcliff Candy Co.* is inapposite. Here, petitioner's expenditures were made for the ultimate purpose of acquiring the Parkway stock, not simply for acquiring a conditional purchase agreement. Whatever may have been the value of the contracts at issue in *Briarcliff Candy Co.*, the Parkway stock was a distinct asset with a readily ascertainable fair market value, as evidenced by the price that petitioner paid to acquire the shares.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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